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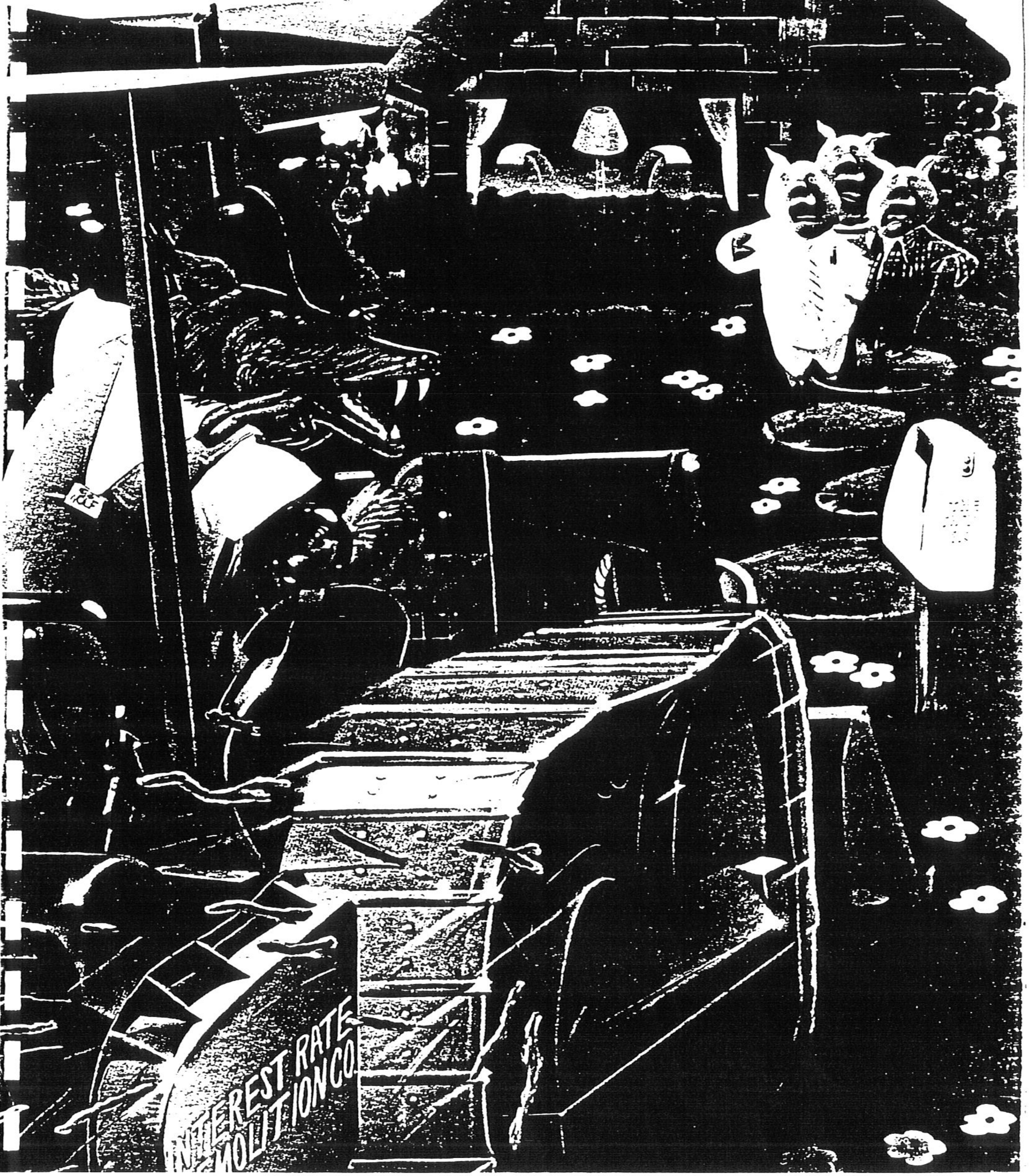

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REAL ESTATE SYNDICATIONS: SHELTERING YOUR INCOME

Richard J. DiGeronimo

Real estate, for the sophisticated investor, is still one of the most attractive tax shelters. Its availability and tax incentives provide investors with a sound economic approach to the sheltering of income. In this sense, real estate, when properly leveraged and structured, serves as a viable conduit for present and future cash distributions plus additional tax savings and residual value reversions.

By far the most common form of real estate tax shelter is the real estate syndication. A real estate syndication can be generally defined as "a method by which a real estate professional, commonly referred to as the syndicator or sponsor, obtains investors who provide the funds required to engage in a real estate enterprise. A syndication can be formed to acquire, develop, manage, operate, and market real estate, or to perform any combination of these functions."[1]

Real estate syndications can be organized or formed in a number of ways, not limited to co-ownership, joint ventures, Sub S Corporations, and REITs. The most common form of organization has primarily concentrated on limited partnership offerings as governed by the Uniform Limited Partnership Act (ULPA). A limited partnership may reasonably be defined as "a partnership consisting of two or more persons having as members one or more general partners and one or more limited partners. The limited partners as such are not bound by the obligations of the partnership."[2]

The limited partnership is a very popular method of attracting investment capital for various kinds of business enterprises. It enables an individual investor to obtain the benefits of partnership treatment including the direct flow of tax deductions (most significantly that of depreciation). Limited partnerships also give the investment the limited liability that is available to stockholders of a corporation. Of course, the general partners are liable without limit for the obligations of the limited partnership. This, too, is an advantage, because this liability (unlike the more limited liability of corporate directors) ensures the active participation and interest of the general partners in managing the partnership affairs.

The creation of a "Limited Partnership" has been approved as a matter of law in each of the 50 states. From a practical viewpoint, the proposed real estate venture partnership must be submitted to, and approved by, the attorney general of the state if it is to be a private placement, and by the Securities and Exchange Commission if it is to be a public offering.

The growth of the limited partnership as one of the most common forms of organizing a real estate syndication can be attributed to its limited legal and economic liability, similar to a corporate form of organization, coupled with the individual tax deductions and losses that pass through to the limited partners. A limited partner, therefore, enjoys limited legal and economic liability (i.e., limited to his equity investment and status as a limited partner) but also benefits from the pass-through of the tax deductions generated by the syndicated real estate.

Limited partnership benefits

Some of the positive benefits of a limited partnership form of investment are briefly listed as follows:

- It provides for partial ownership in a major real estate entity.
- It provides for maximum leverage with a minimum cash contribution.
- Freedom of management.
- Minimum risk, with the total exposure being limited to the actual limited partnership cash contribution.
- When properly structured, shelters earnings.
- Possible excess depreciation charges that can be converted into tax dollar savings.
- Prospect of tax-free returns, property appreciation, and capital recovery upon reversion or sale of the property.

Possible negative aspects

The possible negative aspects of a limited partnership include:

- Limited control in the form of management, marketing, and carrying charges as governed by the general partnership agreement.
- Minority interest
- Lack of continuity of life
- Legal classification
- Restrictions against the sale of an investor's syndicated interest.

The limited partner can be characterized as a "passive investor" who enjoys the benefits of limited legal ("non-recourse" rule) and economic liability (subscription dollar cost) with the syndicated real estate serving as a conduit for annual cash distributions and additional tax deductions.

Assessing the offering

In analyzing a limited partnership offering, careful consideration should be given to the following important elements:

1. Property Economics
   - Locational features concentrating on social and economic growth indicators and trade volume.
   - Present and forecasted income streams.
   - Cash flow analysis on a before and after tax basis.
   - Expense analysis (past, present, and future projections should be analyzed).
   - Underlying and proposed mortgage terms.
   - Residual value potential.

continued

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2. Promoter's financial capabilities and capacity to properly carry and manage the property.
3. Tax Ramifications—near and long-term.
4. Legal soundness.

From an appraisal/consultant viewpoint, the syndicated real estate should initially provide for an appropriate cash-on-cash return, equity build-up (mortgage amortization), and property appreciation potential. All three of these economic criteria should be analyzed with respect to their near-term and long-term benefits and risk elements.

Real estate shelters have reportedly grown into a $30 billion annual industry. The recently enacted Economic Recovery Tax Act of 1981, although limiting some of the prior real estate tax benefits, will not dramatically affect the traditional market or investment demand for properly stuctured real estate investments. Instead, more emphasis will be placed on the particular economics of a real estate syndication as opposed to its immediate tax benefits.

This shift in importance—tax benefits vs. economic elements—can be further attributed to the reduction in the higher income bracket, thus providing for greater profits and higher rates of returns and the lowering of the capital gains tax. The 15 year depreciation recovery period can also limit some of the potential tax losses previously provided by the use of component depreciation. It does, however, diminish the chances of an audit challenge by the IRS.

A decision to invest, or not to invest, should be primarily based on the investment merits of the syndicated real estate as they relate to the individual investor. It is important to note that each investor has a different set of investment criteria that should be analyzed on a deal-by-deal basis. The project (investment) and offering, as structured, should be carefully scrutinized with particular emphasis given to the project's investment merits, projected tax benefits, and likelihood of risk.

Concept		Profit Motive
The seller's primary objective is to maximize profits with consideration given to capital gain and the resulting tax consequences. In this respect, the seller usually split-funds the down payment to defer capital gains over a two to four year installment period.	SELLER/DEVELOPER	To maximize return based on entrepreneurial profit and actual cost analysis. If it is a used property, tax shelter benefits may be depleted and this may affect the potential sheltering of earnings.
The basic concept is to acquire a property that conforms to the basic investment criteria. Syndicator is a fuduciary and, in this respect, is responsible for project financing, management, corrective maintenance, etc.	SYNDICATOR	Partial membership and management of the property acquired. Usually retains wrap or purchase mortgage position at a higher interest rate than the underlying financing. Shares in tax write-offs and future income projections based on individual offering representations. Additionally, passes through the majority of costs, both hard and soft, associated with the acquisition of the project to the limited partnership over a deferred capital contribution period.
The limited partnership's primary investment motive is partial ownership in primary real estate with limited risk, management, and liability. The limited partnership buy-in is usually based on a deferred capital installment plan over four to six years. As a result, the property is generally structured based on maximizing leverage and tax shelter benefits with a limited burden of management and risk to the limited partnership.	LIMITED PARTNERSHIP	Initial motives are the sheltering of earnings through mortgage interest deductions and depreciation of the improvements. The second profit motive would be equity growth through cash-on-cash returns and debt reductions (underlying and wrap payments). An increased potential for additional earnings based on increased rentals resulting from lease renewals at "then" higher rental rates and/or average income clauses if applicable is another salient consideration. The final profit motive would be the residual value potential upon financing and/or sale of the syndicated property.

For example, the projected tax benefits may prove too risky unless the project has substantial investment merit coupled with an active, professional, management and corrective maintenance program. Overall, the real estate syndication can be analyzed as a three tier market—Seller/Developer, Syndicator/Sponsor, and Limited Partner—with each level, or tier of investment requiring an individual, analytical approach.

Three tier concept

The analysis of a real estate syndication can be analyzed based on the three tier concept of valuation as follows:

- The first tier of value represents the value relationship between the seller/developer and the syndicator/sponsor.
- The second tier of valuation reflects the value associated between the syndicator/sponsor and the limited partnership.
- The third tier of valuation is the value associated with the reversion potential of the syndicated property upon resale and/or refinancing.

Each of these tiers represents a viable economic real estate entity with a variation in value associated with each tier. The graphic analysis on this page gives further details on the three tier concept of valuation. ☐

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[1]The Arnold Encyclopedia of Real Estate, *copyright 1978 by Warren, Gorham & Lamont, Inc., Boston, Massachusetts.*

[2]UNIFORM LIMITED PARTNERSHIP ACT *(hereinafter cited as ULPA) Section 1. However, under Section 17, they are liable to the extent of their unpaid contributions.*

[3]ULPA *Section 9. Note that various jurisdictions have adopted versions of Section 9 which are slightly different from those of the ULPA. The following are some of the significant changes. Some states permit termination of liability of a general partner upon his removal or failure of re-election.* California, *Deering's* Cal. Corporations Code, *Section 15509(2) (Bancroft-Whitney 1962), as amended (Supp. 1978); Nevada, 4 Nev. Stat. Section 88.100(2).*